Massachusetts Legislative Proposal of Direct Energy 12.15.03

INTRODUCTION

This memorandum describes Direct Energy's proposal for legislation that would amend the Massachusetts Electric Restructuring Act of 1997 ("Act") to further the development of a competitive retail market for electricity in Massachusetts.[1] The proposal is similar in many respects to the manner in which the Texas retail market was restructured by Texas Senate Bill 7, with certain modifications to accommodate the particularities of the Massachusetts market. This memorandum describes the key provisions of the proposal in greater detail, as well as their advantages over other suggested structures for the post-Standard Offer retail market. The key provisions of the proposal include:

- Structural separation of retail and wires functions
  - Utilities can create affiliated Retail Service Providers ("RSPs")
  - Utilities offer retail services (e.g., billing, customer service) to RSPs at tariffed rates; RSPs required to use utility retail services in first year after Standard Offer expires
- Creation of "basic electric service" ("BES") to replace default service and current standard offer
  - BES in place from March 1, 2005 through December 31, 2006
  - BES provided by RSPs, who have full legal responsibility for all retail services that compose BES beginning March 1, 2005
- Auction of right for RSPs to provide BES
  - Initial price for BES set by auction results
  - Auction applies only to residential and small non-residential customers
- Supplier of last resort service ("SOLR") provided by RSP
  - RSPs bid for right to provide SOLR
  - SOLR service for large non-residential customers reflects ISO New England hourly price

I. BASIC MARKET STRUCTURE

A. Structural Separation of Retail and Wires Functions

The most important characteristic of the Direct Energy proposal is the structural separation of the electric utilities' retail and distribution functions. The proposal calls for utilities to file plans for such a restructuring, which would result in two companies where there is now a single retail utility. One of the companies would be responsible solely for the "wires" function; it would own and operate the distribution plant, including customer premises equipment such as meters. The other company would be responsible for the "customer-facing" retail services; that company would own and operate the commodity procurement, billing, customer service, and collections operations. Other retail service providers ("RSPs") would compete with each other and the utility's affiliated RSP ("ARSP") in the newly structured retail

[1] Direct Energy is a subsidiary of Centrica North America.

market. In the Direct Energy proposal, the ARSP would be allowed – but not required – to participate in the new competitive retail market as would any participant (with one exception, discussed further below).

The three main benefits of this approach are:

?? Removes the regulated utility from the retail business, allowing competitive suppliers (including the ARSP) to build relationships with customers as their "electric company;"
?? Allows distribution utility to focus on reliability of distribution and local network systems; and
?? Minimizes the utility's incentive and ability to shift retail costs from the unregulated to the regulated company.

Competitive Retailers Become "the Electric Company"

Under the current structure, customers still view electricity service as essentially a vertically-integrated monopoly. While utilities in Massachusetts no longer own significant amounts of generation, utilities procure it on behalf of nearly all residential customers and provide that service along with distribution and transmission in a bundled retail product. The rates may have been unbundled, but not the service itself. For retail competitors to forge the kinds of relationships that would reward innovation and increased efficiency, they must come to be seen as the "electric company," rather than being seen as, at best, a company that provides one part of what a customer already receives from his utility. The Direct Energy proposal accomplishes this by turning the customer relationship over to retail companies exclusively, creating the maximum incentive for innovation and economic efficiency while still protecting the characteristics of the customer relationship that are central to the regulated utility's business (mainly the reporting of outages and other distribution system issues).

Wires Companies Focus on Core Business

Even after divesting their generation assets pursuant to the Act, Massachusetts utilities have maintained an effective monopoly in the retail residential and small business markets. The desire to maintain this monopoly and exploit it at some point in the future has, arguably, distracted utilities from their core business, which is to provide a highly reliable local network and distribution system. All customers rely on this system to receive their power, regardless of the source of that power. Massachusetts utilities should be placed in a corporate structure that provides an appropriate incentive and focuses the utilities on the reliable provision of delivery service, as opposed to diluting that responsibility with an obligation to provide retail functions.

Structurally separating the wires business from the retail business would force utilities to focus on their core delivery services rather than remaining involved in the vagaries of the retail generation market. Utilities would have no incentive or ability to divert resources from the core business to what would now be competitive, unregulated lines of business. The result would be greater reliability and, perhaps, improved utility financial performance, should this re-focusing on delivery services reduce or eliminate penalties for poor performance.

Costs and Functions More Effectively Separated

Regarding the third point, under the current structure, the retail functions and distribution functions of the utility are not even functionally separated; they coexist in the same company. In implementing the Act, the Department has separated only the commodity generation portion of the retail function, and then only for rate purposes. The responsibility for arranging commodity generation for Standard Offer and Default Service remains with utility employees.

The Direct Energy proposal, in creating two free-standing companies that are structurally separated and subject to a strict standard of conduct, would create strong disincentives to shifting employee functions from the unregulated retail affiliate to the regulated wires company. The former utility employees serving the retail functions would be needed to provide those same services on behalf of the unregulated retail affiliate; the ARSP could not afford to leave behind critical employees or functions in the wires company, even if such an attempt were able to avoid detection in the Department proceedings implementing the proposal. As discussed below, under the Direct Energy proposal, in the first year after the Standard Offer expires, other retail suppliers in a utility's service territory would be required to obtain the customer-facing retail services from the ARSP at tariffed rates. This will ensure the maintenance of staffing levels and revenue to cover the cost of providing those services, reducing the incentive to shift functions and costs to the regulated wires company.

Direct Energy believes strongly that this single aspect of its proposal, taken from the Texas experience, is critical to the success of the competitive retail markets in Massachusetts, especially the residential and small business markets. Other plans that do not embrace the structural separation of the wires business from the retail business will always be hampered by an immutable characteristic of such a market structure: competitive suppliers must go head to head with the monopoly utility. So long as utilities believe they have a financial incentive to maintain and, at some point in the future, exploit that monopoly in the provision of retail services, retail competition will remain stunted.[2]

In order to bring the benefits of retail competition to Massachusetts consumers, it may be appropriate to provide financial incentives to utilities that are willing to voluntarily separate their retail and distribution functions in this manner. The Act took this approach with respect to

[2] In this respect, while some commentators attempt to draw an analogy between the generation services market and the long distance telephone market, the more apt comparison is to Federal and state attempts to open local telephone service to competition. While Congress mandated in the Telecommunications Act of 1996 that incumbent local telephone companies open up their markets to competitors in exchange for the right to provide long distance service, neither Congress nor the states imposed any requirement for structural separation of the incumbent's "wholesale" services (the provisions of the local loop to competitors) from its retail services (the local exchange service provided through the local loop). The result has been low levels of competition in the local market for residential customers, even as incumbent telephone companies have been allowed to enter (and expand aggressively into) the long distance market.

divestiture of generating plants which, technically, was not required by the Act. A combination of financial incentives (stranded cost recovery and securitization) plus a *de facto* penalty for retaining ownership (generating plants would have to be transferred to a structurally separated affiliated at a cost equal to the highest per kW sale in the region) made divestiture the clear choice for incumbent utilities in 1997. A similar approach could be effective here, encouraging utilities to support the proposal and reducing the risk that a forced structural separation would be challenged in court.

B. Provision of Wires Services to RSPs by Utility

This aspect of the proposal is essential to accomplishing the goal discussed above of creating strong relationships between customers and retail suppliers. Under the current system, the utility bills customers of competitive suppliers directly for their delivery charges, either as part of a consolidated bill provided by the utility, or in a separate bill where a competitive supplier chooses to bill directly for its generation service. Under the Direct Energy proposal, as in the Texas model, RSPs would, in effect, procure distribution services from the wires company on behalf of their customers. Customers would receive one bill only, from the RSP, which would include all charges.[3] This is analogous to the manner in which many other retail items are purchased and delivered. When ordering a book or CD from Amazon.com, for example, the shipping charge is listed as a line item on the invoice, but payment is made to Amazon.com; one is not billed separately by the shipper.

In the Direct Energy proposal, the distribution utilities would continue to be responsible for customer metering. While utilities should be allowed to continue their monopoly provision of certain metering services for now, they should not, however, be given monopoly control over the data produced by meters. RSPs should have access to customer data produced by whatever metering technology the utility uses (with customer consent). To facilitate the free flow of this data, the DTE would be required to develop standards for the electronic exchange of data among RSPs and electric utilities.

C. Supplier of Last Resort Service Provided by Competitive RSP

Under the current system, the utility provides Default Service, which is available to customers who are not eligible for Standard Offer service and customers who, for whatever reason, may have lost service from a competitive supplier. Under the Direct Energy proposal, because the utility would no longer have a retail operation, an RSP would provide the service that would be available to those who lose service from an RSP. This service would be known as "supplier of last resort" or "SOLR" service. The DTE would select RSPs to serve as suppliers of last resort based upon a competitive bidding process. The proposal contemplates that there

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[3] Although in the first year after the expiration of Standard Offer RSPs would use the utility affiliate to provide billing and customer service, the RSP would retain full legal responsibility for all aspects of the retail customer relationship, including billing and appropriate allocation of payments to the utility affiliate for the retail services provided.

would be one SOLR supplier chosen for each utility service territory, although an RSP could win the bid in more than one service territory.[4]

The SOLR would provide the same type of retail service as it would to other customers, namely generation service bundled with retail services and distribution service procured on the customers' behalf from the utility. While the structure of the service would be the same for all rate classes, pricing would vary, with SOLR for residential customers providing a longer term, more stable price, and SOLR for larger commercial and industrial customers having prices set no less frequently than monthly. The goal of this approach would be to provide a "last resort" service that, while not punitive, would accurately reflect the uncertainty and expense of providing a service with a highly volatile customer base. Because they are generally much better equipped to access the competitive market, more sophisticated commercial and industrial customers would be exposed to far more of the price risk of the spot market than would residential and smaller commercial customers.

II. MAKING THE TRANSITION TO THE NEW STRUCTURE

A. <u>DTE Reviews Utility Restructuring Plans</u>

Distribution companies would be required to file with the DTE by early 2004 a plan for structurally separating (not divesting) their competitive retail business activities from their regulated distribution utility services. Each plan would propose unbundled distribution service rates designed to recover distribution costs only.[5] Each plan would also propose an auction of the right to serve mass market retail customers beginning March 1, 2005, as discussed further below. On and after March 1, 2005, distribution companies would be precluded from offering generation or retail services. At that time, both the former Standard Offer and Default Service mass market customers would be served at retail by the competitive RSPs who were the winning bidders in the auction. The current Default Service would expire at the end of February 2005, along with the Standard Offer.

B. <u>RSPs Apply for Certification Under New Standards</u>

In the market structure proposed by Direct Energy, the financial health of RSPs and other issues related to payment allocation and processing will be of great importance. The Direct Energy proposal recognizes this by requiring RSPs to meet stringent financial assurance standards. RSPs would have to show that they could meet these financial standards upon application to the DTE for certification as a qualified RSP. (Existing retail suppliers would apply for re-certification under the more stringent standards.) Regarding bill payment, the DTE already requires that payments be allocated on a pro rata basis between suppliers and the utility, a current requirement that should be retained in any future scenario. Direct Energy is also amenable to reasonable suggestions for requirements governing a RSP's payments to the utility

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[4] Should an RSP win the SOLR bid in more than one service territory, the SOLR price for each service territory would remain the bid applicable to that service territory.

[5] Due to time constraints in implementing the proposal, unbundling and structural separation could be done based on existing utility revenue requirements, avoiding the need for full rate cases for each utility.

that would put the utility in no worse position than in the current system. In fact, to the extent that highly financially qualified RSPs would be taking on all of the credit risk, the utilities' overall risk should decline, as they would have as "customers" a comparatively small number of RSPs rather than several million individual customers under the current system.

RSPs would be subject to the consumer protection provisions currently imposed upon competitive suppliers; the existing provisions would be modified to provide greater flexibility in meeting disclosure and metering requirements and to facilitate properly-authorized switches of a customer's RSP. RSPs would provide the same low income discount that is currently available to utility customers, which would be funded through a charge that would be collected from all customers.

C. <u>DTE Auctions Right to Serve Mass Market Customers</u>

A key provision of the Direct Energy plan is the means by which mass market retail customers make the transition to the post-Standard Offer market. As contemplated under the Act, Standard Offer customers who did not choose a competitive supplier would be automatically switched to Default Service on March 1, 2005.

Under the Direct Energy proposal, the right to serve the mass market (residential and small commercial) customers of each utility would be auctioned to one or more RSP.[6] The winning RSPs would provide "basic electric service" ("BES") to these customers for the period from March 1, 2005 through December 31, 2007. The price for BES would be fixed for the period from March 1, 2005 through February 28, 2006. From March 1, 2006 through December 31, 2007, RSPs could change the BES price no more than once every six months, upon application to the DTE. After 2007, BES would expire. Customers would remain with the RSP that had provided them with BES. RSPs would thenceforth charge competitive, market-based prices. The need to keep customers from switching to other RSPs in the first few months after the expiration of BES would provide a significant incentive for RSPs to keep prices as competitive as possible.

This plan wold accomplish two goals. First, under the auction proposed by Direct Energy, mass market customers would enjoy an additional year of price stability after the Standard Offer expires. This period would provide a cushion in the transition to a competitive retail market, but under a structure that still reflects a market-based price for electricity.

Second, the auction would provide RSPs with a means of scale entry into the Massachusetts market, encouraging the participation of non-utility-affiliated RSPs. This is the one aspect in which the Direct Energy proposal differs from the Texas model. In Texas, all mass market customers were transferred to the utility-affiliated retail provider as of January 1, 2002. While Texas has, nonetheless, seen very robust retail competition, Direct Energy believes the

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[6] The cut-off for inclusion in the auction would be around the 25 kW of peak demand level. Because the auction would occur on a utility-by-utility basis, one option would be to use existing rate classes to determine the pool of customers to be included in the auction.

opportunity for scale entry by non-utility-affiliated RSPs will be important to attract a sufficient number of market participants, especially given that not all utilities are interested in remaining in the retail business.

Under the Direct Energy proposal, utility affiliates would be allowed, but not required, to participate in the auction of mass market customers, including in the utility's own service territory. However, like the Texas model, under the Direct Energy proposal, the affiliated RSP (ARSP) would be prohibited from competing against non-affiliated RSPs to acquire additional residential and small commercial customers in the ARSP's affiliated utility service territory. As in Texas, this prohibition would expire once the switch rate in the *number* of residential and small commercial customers switched to a non-affiliated RSP exceeded 35%. This threshold could be met upon completion of the initial auction. Thus, for example, if the ARSP acquired 40% of the customers in its affiliated service territory in the initial auction (meaning that the remaining 60% went to non-affiliated RSPs), the ARSP could begin marketing to acquire additional customers immediately. If, however, the ARSP acquired 80% of the customers in its affiliated service territory, it could not attempt to acquire more customers until the total number of residential and small commercial customers being served by non-affiliated RSPs in its service territory exceeded 35%.

D. Utility-Affiliated RSP Provides Retail Services Through Tariff

Another important consideration in the transition between the current market structure and one in which the utility wires and retail functions are structurally separated is mitigating the impact of the separation on the utility and its affiliate. There is genuine concern that should a significant number of retail customers be transferred to non-affiliated RSPs as a result of the auction, the utility's fixed retail costs, which were designed to meet the demand of all of the customers in the utility service territory, could be stranded to some extent.

To address this concern, in the first year of the new market, competitive RSPs would be required to purchase certain retail services (mainly billing and customer service) from the ARSP at tariffed rates set by the DTE during the utility's restructuring case. This would provide the utility with a full year to adjust its operations for the new market. It would also assure that the quality of basic retail functions such as billing would not degrade when the new market structure takes effect. During that first year, non-affiliated RSPs would be able to plan their own retail operations so that they would be prepared to take over those functions beginning in the second year, to the extent they so desired. Non-affiliated retailers could continue, if they wish, to purchase those services from the ARSP pursuant to a privately-arranged contract. The strong demand that would arise for billing and customer service operations on the part of non-affiliated providers of BES would give the ARSP an incentive to maintain or improve the quality of the retail services it would make available to other RSPs for resale.

CONCLUSION

Massachusetts electricity customers have received many benefits as a direct and indirect consequence of the Act. Thousands of megawatts of new, efficient plants have been built in Massachusetts and New England. Utility-owned generating plants were divested while at their most valuable. A robust wholesale market has developed. Now is the time to move beyond these gains and secure the benefits of a competitive retail market for all customers, not just the large industrial customers who currently account for nearly all of the electricity sold by competitive suppliers. The best way to bring the benefits of competition to all retail customers is to create a market structure in which retail service must be provided through true retail companies, and those functions are separated from functions that should remain the responsibility of local utilities. Direct Energy's proposal takes this critical step, and does so in a manner that will maximize the benefits to consumers while protecting the interests of all other stakeholders as well.